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northwest economic indicators

NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

National Outlook

July 17, 1980

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Highlights

- **The current recession will be the second-worst tumble during the post-war period. The unemployment rate will approach ten percent, well above the previous peak of nine percent.**
- **Even though a flood of economic bad news will continue, the steepest decline is behind us. Economic weakness will shift from autos and housing to inventory and capital spending.**
- **The economic rebound, which should commence sometime during the first half of next year, will be slow and gradual. The combination of weak purchasing power, the need to increase the savings rate and depressed consumer confidence will make a recovery in consumer spending long and difficult.**
- **Fuel and mortgage rates have been over-stating the true inflation picture. In coming months, the same factors will tend to understate price increases. The underlying core rate of inflation will continue to advance at a double digit rate.**
- **Slack loan demand and sluggish monetary growth will lead to downward pressure on interest rates well into 1981.**

Entering a cold lake, a swimmer can either ease in a little at a time or simply jump right in. Similarly, a business cycle downturn can be entered gradually or with a steep, rapid fall. In each case, the method of entry has no relationship to the final comfort level associated with the changed environment.

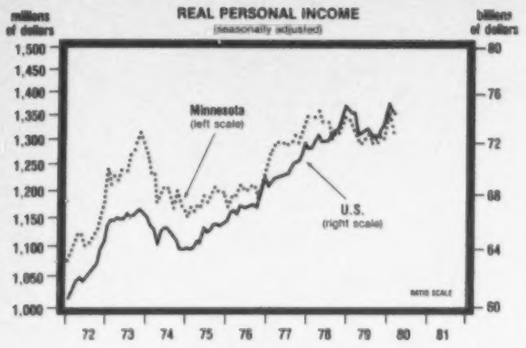
The U.S. economy is now very much like the swimmer who has jumped into icy water and has not yet come up for the first breath of air. The pain is acute and the question exists as to how long the pain will exist. The sharp deterioriation in economic activity witnessed throughout the second quarter of this year has indeed proved a sobering experience. The problem now is one of defining the probable shape of the current phase of the business downturn.

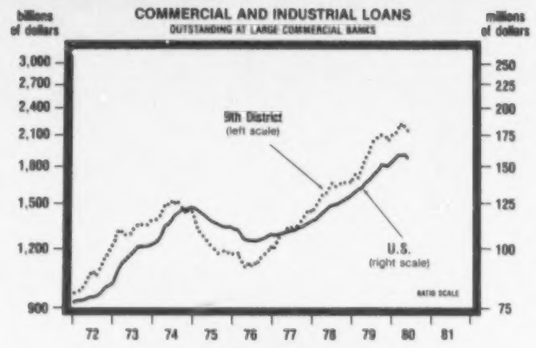
Business and the Consumer

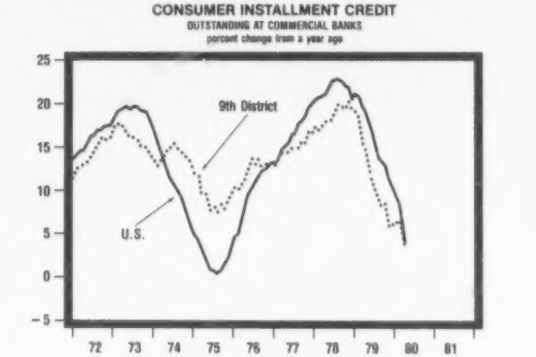
Spending, which determines the level of economic activity, is conducted by several broad economic sectors. Consumers, businesses, governments and foreigners all represent different spending groups, and changes in spending by one or more of these groups can affect the level of economic activity. The question is: which sector has contributed most to the current downturn?

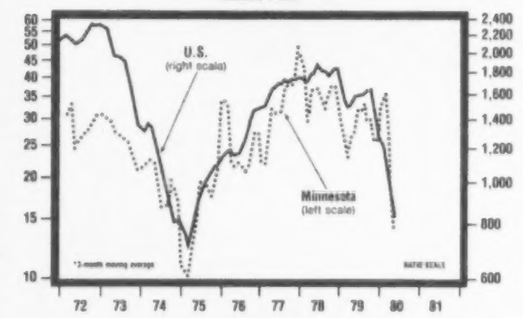
Business spending was a major villain in the 1974-75 recession. Due to rapid rises in the prices of many raw materials in the period immediately preceding that recession, businesses, exhibiting the same form of inflationary psychology recently attributed to consumers, went on a buying spree. The heavy accumulation of inventories by businesses in 1973 and early 1974 greatly reinforced the severity of that recession. When consumer spending began to slow down in 1974, businesses were forced to cut back spending not only because of softening sales activity, but also because of the need to get rid of the excessive inventories which they had accumulated earlier. This inventory decumulation reached nearly $45 billion peak to trough in the last recession, compared to the approximate $10 billion reduction in inventories which characterized earlier postwar recessions.

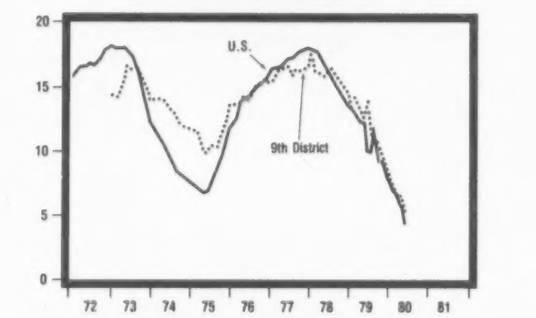
REGIONAL ECONOMIC CONDITIONS

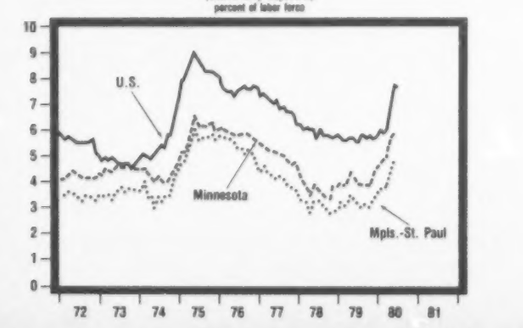


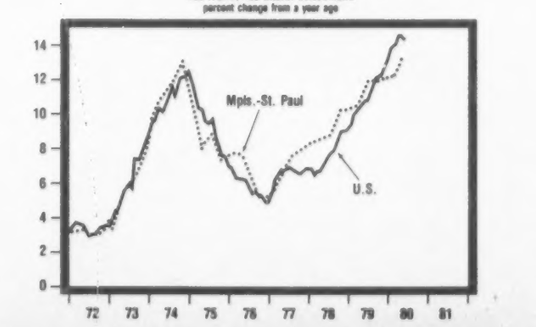

COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS
billions of dollars
millions of dollars
9th District (left scale)
U.S. (right scale)
RATIO SCALE
72 73 74 75 76 77 78 79 80 81


CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago
9th District
U.S.
72 73 74 75 76 77 78 79 80 81


HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units
U.S. (right scale)
Minnesota (left scale)
*3-month moving average
RATIO SCALE
72 73 74 75 76 77 78 79 80 81


MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago
U.S.
9th District
72 73 74 75 76 77 78 79 80 81




CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago
Mpls.-St. Paul
U.S.
72 73 74 75 76 77 78 79 80 81

The bad experience of 1974-75 apparently taught businesses a lesson. Throughout the expansionary period since the last recession and even into the early months of the current recession, businesses have been very careful in their attempts to maintain inventory levels. Consequently, despite the fact that rapidly falling final sales are now leading to some accumulation of unwanted inventories, the size of the real inventory correction in this recession is likely to be less severe than in 1974-75.

This recession is a consumer-induced recession. The importance of consumers and changes in their spending behavior should never be underestimated, since consumer spending accounts for about 65% of total expenditures in the United States.

Faced throughout last year with an inflationary situation that caused substantial deterioration in purchasing power, consumers dipped into savings, took equity out of their houses, and added installment debt at a record pace. Much of this was done as an inflation hedge.

There is, of course, a limit to consumers' ability to spend beyond their means. And this limit was approached in the early months of this year. In addition, the imposition of selective controls on consumer credit extensions by the Federal Reserve in March reinforced the consumer retrenchment pattern which had already begun.

Retail sales, which began to slide in February, have continued to decline up to the present. The particularly distressed conditions in the automobile and residential construction industries certainly need no further explanation other than to say that the earlier problems of escalating fuel prices, fears of gas shortages and a mortgage crunch have now been followed by a cautious recessionary psychology on the part of the consumer.

To summarize, consumers ended their spending spree abruptly in the first quarter and triggered what is now considered a sharp, severe recession. The corollary to this is that the consumer must now play the major role in any economic recovery. The resumption of consumer spending patterns conducive to both economic growth and relative price stability will not be easy to achieve, however, and will not occur simply because the consumer has been invited to use credit cards again.

Inflation and Purchasing Power

Contrary to government claims, the corner has not been turned on inflation. The basic, core pressures on inflation that existed earlier in the year remain today.

Temporary respite is presently being experienced in the rate of increase in both the producer price index and the consumer price index. But, just as sharply rising oil prices and mortgage rates overstated the CPI earlier this year, a slower rate of oil price increases and the substantial absolute drop in interest rates in the past three months will cause the CPI to understate the extent of inflationary pressures.

Lurking in the background is the sharp rise in production costs this year. Strains on productivity from both structural and cyclical causes are being accompanied by labor compensation increases at or above the 9.5% ceiling recommended by the wage and price guidelines. Together, these forces are effectively placing an approximate 10% floor on the core rate of inflation.

Consequently, these core inflationary pressures will continue to make substantial gains in purchasing power difficult to attain until well into 1981. Moreover, added to this situation is the need for consumers to reduce debt. Higher savings rates mean that the percentage of current income devoted to consumption expenditures will also be relatively low in the months ahead.

All is not gloom and doom, however. Consumers have already begun to rebuild liquidity. Labor productivity will improve as declines in employment begin to outpace declines in output, a normal cyclical phenomenon. As the recession stretches on, workers who have not lost their jobs will begin to feel more financially secure and will become more willing to spend and take on additional debt. Inventory adjustments will be completed and businesses will begin to increase their orders leading to first a slowdown and then a reversal in the pattern of the unemployment rate. Moreover, long before these improvements become evident, the Federal Government will be applying stimulative measures.

The Outlook

The combination of a recession and a presidential election is likely to prove to be too inviting a situation for Congress and the Administration to resist. Despite the inflationary concerns described above, a tax cut proposal at the very least can be expected well in advance of the elections in November. Whether such a cut, which if history is any judge would be strongly oriented toward the consumer, would take effect later this year or at the beginning of 1980 is not particularly important. The knowledge on the part of the voting public that it is coming would serve political aims while that same knowledge would also lead to some anticipatory spending by consumers.

A highly visible withholding tax decrease can be expected to prevail over a rollback in social security rate and base increases scheduled to take effect next January . Intuitively, a tax cut should be politically preferable to the postponement of a tax increase. There is no doubt that the Federal budget will not be balanced in fiscal 1981. The only question now is how large that deficit will be, with a very substantial deficit being all but certain.

On the monetary and credit side, recent sharp declines in interest rates should not be interpreted as expansionary monetary policy. The Federal Reserve is maintaining its emphasis on keeping money supply growth within a target range and allowing market forces to determine interest rate movements. Despite election year pressures, the Fed is expected to be successful in continuing this policy stance.

The decline in long-term rates combined with the lagging decline in the prime rate compared to other money market rates has shifted corporate borrowing activity sharply into the capital and commercial paper markets in recent months. The decline

ECONOMIC OUTLOOK
July 1980

	Level			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
				1980E				1981E						
	1979	1980E	1981E	I	IIE	IIIE	IVE	IE	IIE	IIIE	IVE	1979	1980E	1981E
Consumer Price Index (1967 = 100)	217.6	246.7	267.3	16.9	14.0	8.4	7.8	7.4	8.2	8.2	9.6	11.3	13.4	8.4
Food	234.9	252.3	278.3	6.0	5.0	9.0	12.1	11.2	10.5	10.0	9.0	10.9	7.4	10.3
Nonfood Commodities	195.0	222.9	241.5	20.5	12.2	8.6	7.7	7.2	8.6	8.0	10.0	11.7	14.3	8.3
Services	234.4	268.5	288.8	18.6	17.2	7.9	6.3	6.0	7.0	7.6	9.5	11.0	14.6	7.6
Producer Price Index, Finished Goods (1967 = 100)	216.1	243.8	270.2	17.0	9.5	9.5	11.0	11.2	11.2	11.0	11.1	11.1	12.8	10.8
Compensation Per Manhour, Nonfarm Private (1967 = 100)	247.9	271.2	298.6	10.2	9.1	9.4	10.0	11.0	10.5	9.5	9.0	8.9	9.4	10.1
Labor Productivity, Nonfarm Private (1967 = 100)	115.7	113.3	112.4	– 1.7	– 5.0	– 3.0	– 1.0	– 1.0	0.4	1.0	2.0	– 1.1	– 2.1	– 0.8
Unit Labor Costs, Nonfarm Private (1967 = 100)	214.3	238.9	264.8	11.9	14.1	12.4	11.0	12.0	10.1	8.5	7.0	10.2	11.5	10.8
Corporate Profits After Taxes, bil. $	144.0	129.2	112.9	33.8	– 50.9	– 40.0	– 20.2	– 12.6	5.0	25.0	40.0	18.5	– 10.3	– 12.6
Disposable Personal Income, bil. $ (1)	1624.2	1758.9	1891.9	13.5	2.0	4.0	6.0	6.0	10.0	12.0	15.0	11.4	8.3	7.6
Real Disposable Personal Income, bil. $ (2)	746.4	713.0	707.8	– 2.9	– 10.5	– 4.1	– 1.6	– 1.4	1.8	3.3	4.9	0.1	– 4.5	– 0.8
New Passenger Car Sales (millions of units)	10.7	8.6	8.6	10.7*	8.0*	8.0*	7.8*	8.3*	8.7*	9.0*	8.5*	10.7*	8.6*	8.6*
New Private Housing Starts (millions of units)	1.7	1.0	1.3	1.3*	0.9*	0.9*	1.0*	1.1*	1.2*	1.4*	1.5*	1.7*	1.0*	1.3*
Unemployment Rate, %	5.8	7.6	9.1	6.1*	7.5*	8.0*	8.9*	9.5*	9.2*	9.0*	8.7*	5.8*	7.6*	9.1*
Federal Government Deficit, bil. $	11.4	47.9	61.3	22.9*	38.5*	60.0*	70.0*	80.0*	70.0*	50.0*	45.0*	11.4*	47.9*	61.3*

E—Estimated.

(1) Take-home pay.

(2) Disposable personal income divided by the CPI.

*All figures are expressed as annual rates, not percent changes.

ECONOMIC OUTLOOK (Without Inflation)

July 1980

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
	1979	1980E	1981E	1980E I	1980E IIE	1980E IIIE	1980E IVE	1981E IE	1981E IIE	1981E IIIE	1981E IVE	1979	1980E	1981E
Gross National Product	1431.6	1405.9	1404.2	1.2	-9.6	-5.9	-1.2	-0.2	4.6	4.1	3.7	2.3	-1.8	-0.1
Consumer Expenditures	924.5	912.9	917.9	0.5	-10.9	-3.4	0.6	2.0	2.6	3.3	3.7	2.6	-1.3	0.6
Durables	147.1	127.1	123.8	-3.4	-48.0	-9.8	-3.6	3.1	6.2	10.5	10.3	0.3	-13.6	-2.6
Nondurables	349.1	349.3	351.1	-1.1	-5.2	-3.5	1.1	1.6	1.8	2.0	2.1	1.7	0.0	0.5
Services	428.3	436.5	443.0	3.2	0.0	-1.5	1.3	2.0	2.2	2.5	3.2	4.3	1.9	1.5
Investment	215.1	186.5	173.6	-8.3	-18.9	-26.7	-14.7	-19.7	30.9	8.2	11.0	0.4	-13.3	-6.9
Fixed Residential (1)	56.6	41.9	37.3	-26.2	-50.0	-40.0	-35.8	-5.0	22.1	35.2	40.8	-5.8	-26.0	-10.9
Fixed Nonresidential (2)	148.8	146.8	135.7	1.9	-9.3	-6.3	-5.3	-15.1	-5.0	-3.0	0.5	6.2	-1.4	-7.5
Structures	48.1	48.4	44.3	1.6	-13.5	-7.0	-4.8	-15.2	-6.7	-3.4	-2.1	9.6	0.5	-8.4
Producers Durable Equipment	100.7	98.4	91.4	2.0	-7.2	-6.0	-5.5	-15.0	-4.1	-2.8	1.8	4.6	-2.2	-7.1
Change in Inventories	9.7	-2.2	0.6	0.3*	1.8*	-5.0*	-6.0*	-9.0*	2.3*	4.0*	5.1*	9.7*	-2.2*	0.6*
Net Exports (3)	17.6	27.7	32.2	25.0*	27.0*	28.7*	30.0*	33.0*	31.0*	33.0*	31.8*	17.6*	27.7*	32.2*
Exports	119.9	131.0	135.3	131.7*	131.0*	130.2*	131.0*	134.0*	134.0*	137.0*	136.1*	119.9*	131.0*	135.3*
Imports	102.3	103.3	103.1	106.7*	104.0*	101.5*	101.0*	101.0*	103.0*	104.0*	104.3*	102.3*	103.3*	103.1*
Government Purchases	274.3	278.8	280.4	4.2	-1.5	-1.1	0.3	1.6	0.6	1.4	1.2	0.4	1.6	0.6
Federal	99.4	103.7	105.2	13.2	-4.0	-0.5	4.2	1.0	2.1	2.0	1.4	0.8	4.3	1.4
State and Local	174.9	175.1	175.2	-0.7	0.0	-1.5	-1.9	1.9	-0.3	1.0	1.1	0.2	0.1	0.1

E—Estimated

(1) Includes consumer purchases of homes and landlord's purchases of durable goods.

(2) Is roughly equivalent to capital spending.

(3) Exports less imports.

*All figures are dollars, not percent changes.

in bank loan demand has contributed to the weak monetary growth. Given the poor outlook for business activity until well into the first half of next year, loan demand and money supply growth will remain constrained until then. Interest rates can therefore be expected to decline further throughout this period. Moreover, the expected weakness of the economic recovery will tend to dampen the pace of interest rate increases when they finally do turn upward.

Although somewhat different in nature, the present recession will approximate the previous one in severity. It is still relatively early in the downturn, and economic statistics will continue to reflect a deteriorating situation for many more months. Corporate profits will show much sharper deterioration in the months ahead as the inability of businesses to raise prices in a weakening economy squeezes profit margins.

Moreover, the outlook for the housing and auto industries, the two sectors which have led the way into this recession, remains relatively bleak. Declining mortgage rates, while having a positive influence on the housing market, will not give much assistance to new housing starts in 1980. A large inventory of resale houses combined with seasonal factors and construction start-up lags will push the beginning of the housing recovery well into 1981. The auto industry will introduce its 1981 models in the depths of recession. While increased variety and availability of fuel-efficient models will help Detroit in 1981, the recession and consumer knowledge of further major changes in auto technology due in the near term will continue to depress auto sales.

In general, the outlook now is for an "L-shaped" recession as opposed to the "U-shape" of the previous recession. The unemployment rate, which peaked at nine percent in 1975, will peak nearer ten percent next year due in large part to the tremendous growth of employment over the past five years as labor was substituted for capital.

Consumer price increases, after slowing in the summer months, will begin rising more rapidly in the fourth quarter as food prices begin to accelerate from the relatively low levels seen so far this year. As mentioned previously, continuing inflationary pressures will make a recovery in consumer spending that much more difficult to achieve.

A long and deep recession is now well under way. Its causes are understandable and its eventual end is certain. But, right now, the water seems awfully cold.

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